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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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Worker Classification Issues

One of the most common areas of contention between the IRS and businesses is the issue of worker classification. If a worker is an employee, the business is responsible for payroll taxes and fringe benefits. However, if the worker is an independent contractor, the business is generally not responsible for payroll taxes.

The IRS estimates millions of workers are misclassified as independent contractors, depriving the federal government of huge sums of tax revenue. Consequently, the IRS is focusing on worker classification issues and has several audit initiatives in progress.

If a business incorrectly treats an independent contractor as an employee, the business will unnecessarily pay FICA and FUTA taxes and collect FIT withholding. However, if the business incorrectly treats an employee as an independent contractor, the business—

- may risk increased income and FICA taxes, penalties, and interest;
- may owe back FUTA taxes, with penalties and interest;
- may owe back pay and overtime under wage and hour laws;
- may jeopardize qualified benefit plans;
- may jeopardize other benefit plans;
- may be liable for the retroactive effect of reclassifying workers under state workers' compensation and disability statutes, and state mandated benefits (such as parental leave or vacation time);
- may not be in compliance with other federal laws that only apply if the number of employees equals or exceeds certain thresholds (OSHA, ADA, FMLA, etc.); and
- may face other risks [for example, increased business liability for workers' actions and liability for failing to obtain a Form I-9 (Employment Eligibility Verification) upon hiring the worker].

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Classifying workers incorrectly can have significant consequences—from past due payroll taxes to fringe benefit plans. Thus, businesses should exercise due diligence when classifying workers as independent contractors.

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Business Owner's Relatives May Qualify for New Payroll Tax Breaks

The Hiring Incentives to Restore Employment Act (the HIRE Act) includes two temporary payroll tax breaks intended to boost hiring. An interesting point about these breaks is that they could be claimed for a business owner's newly hired spouse. They might also be claimed for wages paid to other newly hired relatives of a *minority business owner* (a person who owns 50% or less of the employer, after considering both direct and indirect ownership). The information below summarizes how the two tax breaks can apply for wages paid to spouses and other relatives of business owners.

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Social Security Tax Exemption for Wages Paid to Eligible New Hires

Wages paid by a private-sector business (large and small alike) to a qualified new employee between March 19, 2010 and December 31, 2010, are exempt from the 6.2% employer portion of the social security tax. The maximum amount of employer social security tax savings for a high-paid employee is $6,622 (6.2% × $106,800 social security tax ceiling for 2010). However, the actual savings realized will be less for high-paid workers who are paid less than $106,800 between March 19, 2010 and year-end.

Qualified new employees are full-time or part-time workers who start work between February 4, 2010 and December 31, 2010, and who provide the employer with a signed IRS Form W-11, Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit, certifying that they were not employed more than 40 hours during the 60-day period ending on their start dates. However, the new worker cannot replace another worker unless that person quit voluntarily or was discharged for cause.

Employer Is a Sole Proprietor. When the employer is a sole proprietorship or a single-member LLC treated as a sole proprietorship for tax purposes, wages paid between the specified dates to the taxpayer's (owner's) newly hired spouse are eligible for the temporary social security tax exemption if the spouse meets the preceding definition of a qualified new employee. Wages paid to other newly hired relatives of the owner (including in-laws) generally will be ineligible.

Employer Is a Corporation. When the employer is a corporation, wages paid between the specified dates to a *majority shareholder's* newly hired spouse are eligible for the temporary social security tax exemption if the spouse meets the definition of a qualified new employee. (A majority shareholder owns more than 50% of the employer, after considering both direct and indirect ownership.) Wages paid to other newly hired relatives of a majority shareholder (including in-laws) generally will be ineligible. However, wages paid either to a newly hired spouse or other relative of a minority shareholder are eligible if the new hire meets the definition of a qualified new employee and is not a relative of the majority owner.

Employer Is a Partnership. When the employer is a partnership (including a multimember LLC treated as a partnership for tax purposes), wages paid between the specified dates to a majority partner's newly hired spouse are eligible for the temporary social security tax exemption if the spouse meets the definition of a qualified new employee. (A majority partner owns more than 50% of the employer, after considering both direct and indirect ownership.) Wages paid to other newly hired relatives of a majority partner (including in-laws) generally will be ineligible. However, wages paid to a newly hired spouse or other relative of a minority partner are eligible if the new hire meets the definition of a qualified new employee and is not a relative of the majority partner.

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Volkswagen Hybrid Vehicle Credit Phases out

The Alternative Motor Vehicle Credit phases out once the manufacturer sells 60,000 qualifying vehicles. Because Volkswagen reached the 60,000-vehicle sales limit during the quarter ending March 31, 2010, the credit for qualified vehicles manufactured by Volkswagen began to phase out on July 1, 2010. For vehicles purchased from July 1, 2010 through December 31, 2010, the credit is 50% of the otherwise allowable amount. For vehicles purchased after December 31, 2010, no credit is allowable—not because of the phaseout, but because the credits expire for vehicles purchased after that date.

Closed-end Fund Information Website

A closed-end fund, like a mutual fund, is a corporate entity that is normally a regulated investment company. Unlike mutual funds, the capitalization of a closed-end fund is fixed at a given level. Once the shares in the initial public offering are sold, shares are acquired and sold through stock exchanges or in the over-the-counter market. The price of shares is dictated by the market [i.e., the price is based on supply and demand rather than the net asset value (NAV) of the shares]. Closed-end funds generally trade at a premium or discount to their NAV.

CEF Connect at **www.cefconnect.com** offers free information to identify and evaluate closed-end funds. Sponsored by Nuveen Closed-End Funds, this website offers daily pricing information, a fund screener, a fund sorter, and an education center featuring basic and advanced information on closed-end funds. This website also offers the previously mentioned premium and discount information for closed-end funds.


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Business Owner's Relatives May Qualify for New Payroll Tax Breaks

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Tax Credit for Retaining Eligible New Hires

In addition to the social security tax exemption, employers can also claim a new temporary tax credit of up to $1,000 for wages paid to each qualified new employee who is retained for at least 52 consecutive weeks. Wages paid during the second 26 weeks of the 52-week period must equal at least 80% of wages paid during the first 26 weeks of that period. The definition of a qualified new employee is the same as for the social security tax exemption.

The credit amount equals the lesser of 6.2% of wages paid during the 52-consecutive-week period, or $1,000. To claim the maximum $1,000 credit, the worker must be paid at least $16,130 during the 52-week period.

Here's the important point: even if the new hire is a spouse or relative of a business owner and is eligible for the social security tax exemption, wages paid to that spouse or relative may also be eligible for the new employee retention credit. That's because the definition of a qualified new employee is the same for both breaks.

Time Is of the Essence

If you have questions or want more information about the temporary social security tax exemption or the temporary new employee retention credit, please contact us. The eligibility rules in family business situations are complicated, and these breaks will soon expire.

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Donating a Life Insurance Policy to a Charity

Many people would contribute more to charity if they could afford it. One often-overlooked asset that could be donated to charity is a life insurance policy that is no longer needed for its original intended purpose. Individuals who might be receptive to this type of charitable gift include those still carrying large amounts of life insurance even though the major financial obligations in their lives have been met.

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Of course, good reasons may exist for keeping the policy in force (such as to provide liquidity for a taxable estate or to meet the continuing needs of a surviving spouse or disabled child). Other times, the best option simply will be to cancel any excess coverage, convert it into a paid-up policy with a lower face amount, or sell the policy in a life settlement transaction. Still, for clients with both excess life insurance and a charitable intent, the donation of a life insurance policy may make sense. However, the donation must be handled correctly for the policy owner to get the maximum tax benefits. Here's the deal.

Seizing on this situation as an opportunity, some charities ask their donors to consider donating life insurance policies rather than (or in addition to) cash in order to make substantially larger gifts than would otherwise be possible. The advantage to donors is that they can make a sizable gift with relatively little up-front cash (or even no cash, if an existing policy is donated). That a charity may have to wait many years before receiving a payoff from the gift is typically not a problem because charities normally earmark such gifts for their endowment or long-term building funds.

If handled correctly, a life insurance policy donation can net the donor a charitable deduction equal to the value of the policy. A charitable deduction is also available for cash contributed in future years to pay premiums on a policy that was not fully paid up at the time it was donated. However, if handled incorrectly, the deduction is lost. For this reason, we encourage you to contact us if you are considering the donation of a life insurance policy. We can help ensure you receive the expected income or transfer tax deduction and that the contribution works as planned.

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